Feb. 18, 2010

Re: CPI "Bottom Line Report" and SDCTA Review

Dear Chairman Nelson:

We would like to thank the Commission for the opportunity to review the latest report from the Center on Policy Initiatives and the San Diego County Taxpayers Association's review. The purpose of this letter is to provide the Commission a broad overview of the findings, help reconcile apparent areas of disagreement between these two studies, and to highlight several areas that may require additional research and consideration.

Overall, we would like to commend the Center on Policy Initiatives for producing a thoughtful analysis that provides valuable information about revenue options available to San Diego policy makers. *The primary finding of the CPI report — a finding not challenged by the Taxpayers Association—is that San Diego generally collects less revenue than other major California cities and does so because it assesses lower taxes and fees. One important implication of these findings is that San Diego has room to enact revenue enhancements without putting the city at a comparative economic disadvantage that would result from charging higher taxes and fees than competing cities.* We believe that these conclusions are warranted, and are supported not only by the CPI study but other independent analyses of the city's finances.[1] The primary disagreement between CPI and the SDCTA is about the magnitude of the disparity, and the actual amount of additional revenue that would be generated by specific policy changes.

In what follows, we consider specific areas of disagreement between the two organizations, and hope to provide the Commission with some context to help evaluate their competing claims:

1. **SDCTA argues that the CPI analysis makes unsupported economic assumptions.**

After comparing tax rates across different cities, the CPI attempts to estimate the amount of additional revenue that San Diego would have generated had it adopted higher tax rates, holding constant other factors such as consumer behavior and economic factors. The SDCTA argues that holding these factors constant in the analysis provides a misleading picture of fiscal reality because increasing local tax rates is likely to cause other changes in behavior. For example, significantly increasing the local sales taxes may encourage certain local residents to instead shop in other nearby cities that have a

[1] See, for example, Office of the Independent Budget Analyst, "Review of Five-Year Financial Outlook and Budget Balancing Scenarios," IBA Report Number 09-2, January 15, 2009; Thad Kousser, "Is San Diego a Low-Tax City," Report Prepared for the 2005 Mayoral Debate; Kelling, Northcross & Nobriga, "City of San Diego Facilities Financing Study," April 12, 2002.

lower tax rate, and ignoring this behavioral shift would result in us overestimating the amount of new revenue that could be generated from the tax increase.

While this is a valid point, and one that should be kept in mind by policy makers, there is little evidence that the behavioral changes at the heart of the SDCTA critique would *significantly* alter the CPI predictions. This is because most taxes collected by local government are not *salient* enough to generate large behavioral changes.[2] That being said, behavioral elasticities with respect to tax rates are likely to vary across various taxes. For example, we should expect that sales tax increases will result in larger behavioral changes than transient-occupancy tax increases, as it is unlikely that many tourists who want to visit San Diego will choose a different destination in response to a relatively minor change in cost. The primary conclusion that the Commission should draw from this debate is that the CPI estimates of new revenue are simply ballpark figures and should not be used to make exact predictions.

It is important to note that the economic assumptions used by CPI are not unusual. Indeed, the Independent Budget Analyst used similar assumptions in its January 15, 2009 analysis of budget balancing scenarios, as did Kelling, Northcross & Nobriga in the 2002 Facilities Financing Study.

2. **SDCTA argues that the inclusion of San Francisco in the comparison set biases the results of the analysis.**

We are in general agreement with the SDCTA that San Francisco should be excluded from *most* revenue comparisons for reasons outlined in our January 11 letter. Without San Francisco, the difference between San Diego's receipts and the revenue collected by other large cities is more muted, though a significant gap still remains.

However, it may make sense to include San Francisco in *some* comparisons. For example, there is little reason to exclude San Francisco when analyzing transient-occupancy taxes, since its status as a city-county is unlikely to give it access to more TOT dollars or tourism business than is available to San Diego.

Indeed, it is important that the Commission give some thought to the relevance of the ten-city benchmark for specific comparisons. It may be the case that for certain revenue sources, only a subset of these cities — perhaps the largest ones — provide the most meaningful comparison group to San Diego. For example, we are not convinced that Fresno is a valuable comparison with respect to TOT as it is unlikely that raising San Diego's hotel taxes will encourage many tourists to instead choose Fresno as their travel destination.

3. **The SDCTA and CPI differ in their calculation of the "average" revenues for the comparison cases.**

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[2] See Raj Chetty, Adam Looney, Kory Kroft, "Salience and Taxation: Theory and Evidence," National Bureau of Economic Research, Working Paper 13330.

Throughout the original "Bottom Line" report, the CPI compared San Diego's revenues to the average (mean) for major California cities. The SDCTA disputes many of these comparisons, and offers alternative calculation of the mean. Our analysis suggests that this disagreement is largely the result of differing methodologies:

1. In calculating the big-city average, CPI includes only the other nine cities. That is, the CPI big-city average *excludes* San Diego.
2. In contrast, SDCTA *includes* San Diego with the other cases and, as a result, finds that the average is closer to San Diego's numbers than does the CPI.

While both methodologies are defensible, we believe the CPI approach is more useful. Because the purpose of the analysis is to compare San Diego's fiscal policy to that of *other* California cities, excluding San Diego from the calculation provides a meaningful measure of the quantity of interest.

4. SDCTA argues that the median, rather than mean, household income should be used as the indicator of a San Diego citizen's "capacity to pay."

CPI concludes that San Diego's tax burden is relatively low when compared to its constituents' household income. SDCTA disputes these conclusions and suggests that the CPI erred in its use of mean, rather than median, income.

In the tables below, we recreate the CPI analysis using *median* per-capita income for both general city revenues and for total city revenues (see point six below).[3] We find that the CPI conclusions are not sensitive to the use of mean, rather than median, income.

City	General Revenue as Percent of Median Income
Fresno	2.13%
San Jose	2.15%
San Diego	*2.17%*
Santa Ana	2.18%
Long Beach	2.46%
Anaheim	2.65%
Sacramento	3.26%
Oakland	3.28%
Los Angeles	3.55%

[3] We use the Fiscal Year 2006-07 *Cities Annual Report* for the revenue data and the 2006-2008 American Community Survey 3-Year Estimates for the median per-capita income.

City	Total Revenue as Percent of Median Income
San Jose	4.7%
Santa Ana	5.5%
Fresno	6.4%
San Diego	*6.5%*
Sacramento	9.4%
Oakland	10.7%
Los Angeles	13.4%
Long Beach	14.5%
Anaheim	16.8%

5. SDCTA notes that the CPI analysis relies on unaudited financial data.

As is the case of many comparative fiscal analyses, CPI relies on the *Cities Annual Report* published by the State Controller's Office. SDCTA correctly notes that the data contained in this report is drawn from unaudited figures. However, without additional evidence to the contrary, we have little reason to believe that the use of unaudited figures and potential accounting differences are serious grounds to reject the CPI's findings. Unless there is some reason to believe that San Diego's accounting practices differ significantly from that of the other nine large cities, and that these differences bias the CPI calculations in a systematic way, the SDCTA critique is unwarranted. Indeed, the fact that Kelling, Northcross & Nobriga, which relied on audited Comprehensive Annual Financial Reports, reached similar conclusions as the CPI provides strong evidence that the CPI conclusions are not driven by the use of unaudited data.

6. Commission should not limit its analysis to "general" revenues.

In the original "Bottom Line" report, CPI focuses its analysis on what the State Controller has classified as "general" city revenues, which the controller defines as "revenues that cannot be associated with a specific service. A second category includes "functional" revenues and refers to "revenues that are either generated from direct services or associated with a specific service." As one critique of the "Bottom Line" report has noted, the most relevant comparison between cities is at the level of total revenues, which combines both general and functional revenue sources, as local policy often dictates whether certain funds are counted as "general" rather than "functional" dollars.[4]

For example, City Council policy and/or voter initiatives direct that certain revenues in San Diego be set aside for specific uses. For example, council policy earmarks a portion of the TOT funds for tourism promotion, a 1972 voter initiative set asides 25

[4] Thad Kousser, "Is San Diego a Low-Tax City," Report Prepared for the 2005 Mayoral Debate.

percent of franchise revenues for the Environmental Growth Fund, and another recent initiative sets aside certain Mission Bay lease revenues for capital projects in the park. Because redirecting such earmarked revenues into the General Fund may represent low-hanging fruit — some of these changes can be made without voter approval or with a simple majority support of voters, compared to the two-thirds vote required for many tax increases — it is important that that the commission consider both "general" and "functional" revenue sources in its recommendations.

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We hope that the Commission finds these comments helpful. We are happy to provide additional details at your request.

Sincerely,

Steven P. Erie
Vladimir Kogan
Scott A. MacKenzie